CADWALADER

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In this week's edition, we discuss a drop in support for ESG shareholder proposals at one of the world's largest asset managers; a decision by a U.S. federal court to strike down an anti-ESG investing rule in Missouri; and Australia's new mandatory climate disclosures law.

Reduction in BlackRock Support for ESG Proposals

According to its own **2024 Global Voting Spotlight report**, BlackRock, the world's largest asset manager, has scaled back its support for environmental and social shareholder proposals, backing just 4% of the 493 proposals put forward in the year leading up to June 2023, a drop from its 47% support peak in 2021. The firm attributed its reduced support to the poor quality and economic viability of many proposals, noting that many were either overly prescriptive or addressed risks already managed by companies. This observation is, according to Morningstar, consistent with the voting trends seen across the top 10 largest asset managers **as we discussed previously**.

This shift comes amid heightened scrutiny of ESG investing and the role of asset managers on this issue. BlackRock has been criticized by both sides of the debate; conservative groups accuse it of promoting "woke capitalism," and environmental advocates argue that it is not doing enough to push for decarbonization. **We have discussed this push-and-pull frequently**.

As discussed previously, on July 2, BlackRock published updated decarbonization investment guidelines, which require funds with specific climate change mandates to consider shareholder proposals that, for example, ask companies to make Scope 3 emissions disclosures. This will allow climate-focused funds to take an activist position on climate proposals put forward by shareholders and represents the asset manager's effort to navigate the political divide over decarbonization. As it stands, all of BlackRock's funds consider climate as a risk factor that affects financial performance, but those that follow the updated guidelines will consider a company's efforts to achieve Paris Agreement-aligned goals.

As we have frequently discussed, asset owners globally are under considerable pressure to ensure that adequate consideration is given to climate risks in line with their fiduciary duties. But they are also subject to lobbying and pressure from non-climate aligned groups. The updated guidelines from BlackRock appear to be its attempt to navigate the various interest groups within their global client base.

Despite the drop in support for environmental and social proposals, BlackRock increased its backing for governance-related measures, supporting 21% of such proposals, compared to 11% last year. These included efforts to protect shareholder rights and strengthen corporate boards. Overall, BlackRock supported 88% of proposals from the companies it invests in, including a strong backing for executive pay and director nominations.

U.S. Federal Court Strikes Down Anti-ESG Investing Rule in Missouri

In August 2024, a U.S. Federal Court **struck down a controversial rule** in Missouri that aimed to curb the influence of ESG factors in investment decisions made by public pension funds. The rule, which became effective in July 2023, required investment advisors and broker-dealers to obtain written consent from clients prior to incorporating a "social objective" or other "nonfinancial objective" into their recommendations or advice. Clients were required to expressly acknowledge that the advice was not focused solely on maximizing financial return. Non-compliance with the rule constituted "dishonest or unethical business practices" under state law.

The rule was challenged in court by a coalition of environmental and social justice organizations, alongside investment firms that specialize in ESG-focused funds. Plaintiffs argued that the rule was overly restrictive and violated federal laws that govern the management of public pension funds, including the Employee Retirement Income Security Act (ERISA). ERISA sets standards for the management of private-sector pension funds and includes a requirement that fiduciaries act solely in the interest of plan participants and beneficiaries. The plaintiffs contended that the Missouri rule improperly constrained the discretion of fiduciaries by prohibiting them from considering ESG factors, even when such factors could be financially material.

In its ruling, the federal court found in favor of the plaintiffs, striking down the Missouri rule on the grounds that it was incompatible with federal law. The court found that the rule effectively forced fiduciaries to ignore potentially relevant financial information, thereby conflicting with their duty under ERISA to act prudently and in the best interest of pension beneficiaries. The judge emphasized that while states have the authority to regulate public pension funds, they cannot enact rules that undermine federal standards or impose undue restrictions on fiduciaries. The court noted that ESG factors, when used appropriately, could be relevant to the long-term financial performance of investments, particularly in areas such as climate risk and corporate governance. The judge also noted that the rule violated free speech provisions of the First Amendment of the United States Constitution, and was unconstitutionally vague.

The ruling has significant implications for the ongoing debate over the role of ESG considerations in financial decision-making, highlighting the legal complexities and divergent perspectives surrounding the issue. It highlights the tension between state-level efforts to restrict ESG investing and federal standards that govern fiduciary responsibilities as we frequently discuss including in this issue in the context of shareholder voting proposals, and **here**.

In recent years, a number of states have introduced legislation aimed at restricting the use of ESG criteria in public pension fund investments. Missouri's rule was part of this broader movement, designed to prevent state-controlled pension funds from considering ESG factors that could be seen as political or ideological in nature. Supporters of the rule argued that it was necessary to protect the financial interests of pensioners by ensuring that investment decisions were based solely on financial considerations.

As well as introducing legislation to restrict the use of ESG criteria, challenges have also been mounted against rules that allow ESG investing such as the Department of Labor (DOL) Rule **we discussed previously**. Plaintiffs had alleged that the rule violated the Administrative Procedure Act because it is arbitrary and capricious and "runs afoul" of ERISA, but the court disagreed.

The decision in Missouri has broader implications for other states that have enacted or are considering similar legislation. It underscores the legal challenges that such rules may face, particularly when they are perceived to interfere with fiduciary duties under federal law. For proponents of ESG investing, the ruling is seen as a victory that reaffirms the legitimacy of considering ESG factors as part of a comprehensive investment strategy. They argue that the decision allows pension fund managers the flexibility to assess all relevant information when making investment decisions, potentially leading to better financial outcomes. But opponents of ESG investing view the ruling as a setback in their efforts to prevent what they see as the politicization of investment decisions. They may seek to challenge the decision or push for legislative changes at the federal level to more explicitly limit the use of ESG factors in public pension fund management.

Australia's New Mandatory Climate Disclosure Law

In August 2024, Australia introduced a new mandatory climate disclosure law, enhancing the country's approach to climate-related financial risks and sustainability. This legislation, set to be phased in starting from the fiscal year 2024-2025, requires large companies to disclose their exposure to climate risks in line with international standards. The law aims to improve transparency and ensure that investors, regulators, and the public are better informed about the financial risks posed by climate change. This development aligns Australia with several other jurisdictions which have mandated climate disclosures including: **the UK**, Brazil, **the European Union**, Hong Kong, Japan, New Zealand, **Singapore** and Switzerland. Each of these countries has adopted the Taskforce for Climate-related Financial Disclosure (TCFD) framework.

Key features of Australia's legislation include:

1. Governance and Strategy: Companies must disclose how they integrate climate risks into their governance and strategic planning processes.
2. Risk Management: Firms are required to outline their processes for identifying, assessing, and managing climate-related risks.
3. Metrics and Targets: Companies must report the metrics they use to assess climate-related risks and opportunities, as well as their targets for reducing greenhouse gas emissions.
4. Scenario Analysis: Organizations are expected to conduct scenario analyses to understand the potential impacts of different climate scenarios on their business models.

The law is aligned with the climate-related reporting requirements of the IFRS Foundation's International Sustainability Standards Board (ISSB), which have been widely adopted by governments and regulators worldwide. The Australian Securities and Investments Commission (ASIC) will oversee the implementation and enforcement of these requirements, ensuring that companies provide accurate and comprehensive information.

The introduction of mandatory climate disclosures is expected to have wide-ranging implications for businesses operating in Australia. Large companies, particularly those in carbon-intensive industries, will need to invest in systems and expertise to meet these new reporting requirements which could lead to increased operational costs in the short term, as companies adapt to the new standards. However, the law also presents opportunities. By improving transparency, companies that manage climate risks effectively may gain a competitive advantage, attracting more investment from environmentally conscious investors.

For investors, the law provides a clearer picture of the risks associated with their investments. This transparency is expected to lead to more informed decision-making and could shift capital towards businesses that are better prepared for the transition to a low-carbon economy.

The introduction of mandatory climate disclosures is part of a broader shift in Australia's climate policy. In recent years, the country has faced increasing pressure to strengthen its response to climate change, both domestically and internationally. One of the most significant recent developments is Australia's commitment to achieving net-zero greenhouse gas emissions by 2050. This target, announced in 2021, represents a substantial change in the country’s climate policy. To support this goal, the government has outlined a series of initiatives, including investments in clean energy technologies, the development of a hydrogen industry, and measures to improve energy efficiency. In March 2024, an Australian court (as opposed to other authorities such as advertising regulators) was also reportedly the first in the world to hold that a company had engaged in greenwashing **as we discussed previously**. And, in November 2023, the government **sought input** on the implementation of a carbon credit scheme. In June 2023, the Australian government **published an updated Statement of Expectations for the Australian Prudential Regulation Authority (APRA)**, requiring it to, among other things, “promote prudent practices and transparency in relation to climate-related financial risks and the adoption of climate reporting standards by regulated entities.”